in the denominator and thereby obviating the FLC entirely. That, however, would be a cumbersome effort that would fundamentally change the nature of the ACF as a factor that makes use of historical relationships. Also desirable though impracticably cumbersome would be an FLC separately computed for each category of investment. The best course for now is to retain the FLC but to adjust it on the basis of the information now available.)

Finally, use of the FLC to avoid double counting the effects of TELRIC requires being sure that the remaining "single count" is not understated. To that end, expense adjustments should be rigorously applied where warranted. These include the productivity adjustment previously discussed, as well as others considered below.

3. <u>Removal of Retail Avoided Costs</u>[96]

Consistent with the premise of the FCC's UNE pricing regulations (since called into question by the Eighth Circuit's decision), Verizon's studies reflected the assumption that Verizon was a purely wholesale company and therefore sought to remove avoidable retail costs from consideration.[97] Verizon

[96] This heading considers Verizon's effort to remove retail avoided costs from its ACF calculations generally. A separate question, discussed below, relates to whether retail activities were properly removed in determining the wholesale marketing ACF.

[97] The FCC required removal of "avoidable" retail costs, while the Eighth Circuit determined that the 1996 Act called only for removal of "costs that are actually avoided," a lesser amount, and rejected the premise that the ILEC would become a wholesale-only provider. Verizon notes that these aspects of the Eighth Circuit's decision were not stayed by the Supreme Court's grant of certiorari and argues that the Commission must take them into account; it reserves its right to submit, after the Commission's decision, a revised study that develops avoided costs in a manner consistent with the Eighth Circuit. As the CLEC Alliance notes, however (Reply Brief, pp. 18-19), the Eighth Circuit's decision pertained to resale rates, not UNEs. Extending it to the calculation of excluded retail costs for purposes of UNE pricing may have the

contends that it conducted a full review of each expense category to determine those that would be avoided in a wholesale-only environment and that its study is more detailed than the study used to determine the avoided cost percentage for purposes of setting the wholesale rate in the Resale Phase of the First Elements Proceeding.

AT&T argues that Verizon should have excluded Universal Service Fund contributions, which are assessed on the basis of retail end-user revenues and therefore would not be incurred in a wholesale-only environment. It suggests that other access-related charges should be excluded as well, but in the absence of information needed to assess their magnitude offers no adjustment on their account; it therefore regards its approach as conservative.

In Verizon's view, the hypothetical wholesale-only environment would likely involve changes in the Universal Service Fund, and it is unlikely that Verizon and other ILECs would be relieved of responsibility for universal service. More fundamentally, it emphasizes the Eighth Circuit's rejection of the wholesale-only premise that underlies the exclusion of Universal Service Fund expenses.

AT&T has not addressed itself to the effect of the Eighth Circuit's approach on its Universal Service Fund adjustment, and Verizon has not presented any estimate of how that decision would affect its figures. The parties may address themselves to this issue further in their briefs on exceptions; for now, Verizon's retail adjustment will be adopted as a placeholder.

4. ACF Versus CCF

As noted, Verizon's ACF method, in contrast to the CCF mechanism used in the First Proceeding, assigns some costs and expenses not on the basis of investment but on the basis of

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benefits of consistency, but the CLEC Alliance presents arguments, on which judgment can here be reserved, against doing so.

expenses or revenues. The CLEC Coalition objects to the change, urging continued use of CCFs. It is concerned in particular about the common overhead ACF, the calculation of which on an expense-to-expense basis results in the assignment of a portion of those overheads to nonrecurring charges, which, because they entail no investment, bear no assignment of common overhead under the CCF method.

Verizon sees the change as an improvement, contending that because all products and elements receive the benefit of the overhead costs, all, including nonrecurring items, should bear a reasonable portion of those costs. The CLEC Coalition, however, regards the change as a gratuitous increase in nonrecurring costs that shifts risk from the ILEC to the CLEC, in an anticompetitive manner, by increasing the upfront charges that CLECs must bear.

In its reply brief, the CLEC Coalition characterizes this as primarily a policy issue, i.e., whether CLECs should bear recurring costs as part of up-front nonrecurring charges. But Verizon argues persuasively that nonrecurring charges should bear a portion of the overhead costs from which they benefit, and the ACF method for allocating those costs appears reasonable.

Network ACF

1. Arguments

Verizon's network ACF, based on actual 1998 data that were reviewed to identify reasonably anticipatable reductions, "includes repair, rearrangement and testing expenses, as well as testing equipment capital costs, plus plant account and general network loadings."[98] In calculating the factor, Verizon assumed a reduction in "R dollars," the costs associated with subscriber troubles, on the premise that such troubles would diminish with the placement of newer copper plant. It did not reduce "M dollars," the expenses attributable to rearrangements associated with customer moves, municipal requirements, and network

[98] Verizon's Initial Brief, p. 54.

upgrades, seeing no basis for assuming that such costs would decline.

AT&T charges that the network ACF should have been adjusted to remove excessive repeat repair costs, which result from poor workmanship and inefficient processes that should be assumed away in a TELRIC context. On the basis of Verizon's service quality reports, AT&T calculates a repeat repair rate of approximately 16%, and it proposes to remove the associated costs from the network ACF. It contends its adjustment may be understated because it eliminated only estimated direct costs associated with certain plant accounts and did not extrapolate potential cascading cost effects of repeat repairs and poor work quality. The CLEC Coalition notes that the repeat repair adjustment should be in addition to any productivity adjustment.[99] Verizon contends, however, that repeat repairs are often attributable to causes other than error and poor workmanship.[100] In any event, it says, the TELRIC construct does not presume perfect performance, and the costs of repeat repair will continue to be incurred in the future.

The CLEC Alliance argues, more generally, that the network ACF is inflated because its numerator (costs) fails to reflect the reduced cost of maintaining new equipment while its denominator (investment) is based on the net book cost of depreciated equipment, much lower than the cost of investment in new equipment required under TELRIC. To correct for the overstated numerator and understated denominator, the CLEC Alliance proposes to reduce the network ACF by 25% (after removal of the FLC factor). It contends that Verizon "is attempting to have it both ways in its effort to recover the increased cost for new, more efficient equipment, <u>and at the same time</u> recover maintenance costs that would be associated with old and increasingly obsolete equipment."[101] The CLEC

[99] CLEC Coalition's Initial Brief, p. 31.

[100] Tr. 3,314, citing AT&T's acknowledgement of that in an interrogatory response.

[101] CLEC Alliance's Initial Brief, p. 12 (emphasis in original).

Alliance disputes Verizon's suggestion that advanced technology will not necessarily reduce repair costs and that increased sophistication of the technology in fact makes repair related problem solving more complex; according to the CLEC Alliance, new technology yields many efficiencies, including reduced maintenance costs. It contends that Verizon has failed to meet the burden of proving its claim that maintenance costs will not decline over time.

In a similar vein, WorldCom cites suggestions by the Commission in the First Proceeding and by Staff in the organizational stages of this case that a new, optimally designed network would incur lower maintenance costs than the existing network. WorldCom contends that the use of fiber feeder and electronics permits rapid expansion of capacity without costly rearrangements, through the use of line cards, and it cites a claim by regional Bell operating company SBC that new loop infrastructure "will substantially reduce the need to rearrange outside plant facilities when installing new or additional services."[102] WorldCom urges that M dollars be reduced by 50% to recognize these considerations, as recommended by AT&T's witness.[103]

Verizon responds that it regularly removes obsolete, high-maintenance equipment from its network, thereby avoiding excessive maintenance costs; that the inclusion of depreciated plant in the current investment base does not overstate expense; and that the CLEC Alliance's 25% reduction in the ACF and WorldCom's 50% reduction in "M dollars" are arbitrary and unsupported. It claims to have explained in detail why there would be no reduction in "M dollars"--moves and rearrangements--in a TELRIC future.[104]

In a more specific point, WorldCom charges that Verizon's network ACF is overstated because of a diminution in

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[102] Exhibit 393, p. 7.

[103] Tr. 1,242-1,243.

[104] Verizon's Reply Brief, p. 36, citing Tr. 2,378.

the adjustment--the copper repair adjustment factor (CRAF)--designed to eliminate recovery of expenses associated with repairing deteriorated copper plant. In the First Proceeding, the "deteriorated copper repair reduction," an important portion of the CRAF, was set at 60%; Verizon here proposes to reduce it to 35% and thereby reduce the overall CRAF from 42% to 25%. The 35% deteriorated copper repair reduction results from averaging the 60% used in the First Proceeding on the basis of a 1996 study with a new estimate of a 10% reduction that, WorldCom charges, lacks evidentiary support and is simply an unexplained estimate. The change increases repair expense recovery by approximately $89 million, thereby wiping out the 2% productivity adjustment included in the ACF. WorldCom goes on to express outrage over Verizon's alleged failure to mention that it reduced the Phase 1 CRAF, and it urges the Commission to reverse this "surreptitious" reduction and set it at 42%.[105]

Verizon responds that it reduced the CRAF to reflect the "commonsensical notion," missed in the First Proceeding, that newer plant already in good condition is less likely to experience large trouble rate improvements in the future. It claims as well to have supported its 10% improvement estimate, which it openly characterized in an interrogatory response as appropriate "for tracking units that would be experiencing excellent service."[106]

2. Discussion

Turning first to the treatment of "M dollars," Verizon has failed to refute the reasonable expectation, expressed by both the Commission and its staff and seemingly adopted by SBC in the document reproduced in Exhibit 393, that moves and rearrangements will be less costly in a forward-looking system. Verizon's testimony says only that "even if...has in place an optimally designed network, it will still be required to

105 WorldCom's Initial Brief, pp. 54-57.

106 Verizon's Reply Brief, p. 34, n. 80.

reconfigure its facilities to reflect new municipal ordinances and movement of customers."[107] That, of course, is true; but Verizon fails to address itself to the extent to which those activities will be less costly than they have been in the past and to the efficiencies cited by SBC. The 50% adjustment to "M dollars" proposed by WorldCom is not specifically supported and seems high; a 30% adjustment should be used unless parties can show on exceptions that a different figure is warranted. Making this adjustment also resolves the CLEC Alliance's concern about the alleged mismatch between the numerator and denominator of the ratio: consistent with the general approach with respect to ACFs, the numerator is forward-looking while the denominator reflects historical plant investment.[108]

Verizon correctly argues that repeat repairs cannot be attributed exclusively to a shoddy initial effort, as AT&T would imply. But there can be little doubt that at least a portion of such repairs do flow from difficulties associated with the initial work; and Verizon's carrier-to-carrier metric reports, which refer, among other things, to installation troubles, bear out that inference. Finally, Verizon's adjustment to the CRAF was neither surreptitious nor unexplained, and it makes sense in concept. The specific 10% figure is inadequately supported, however, since there is no reason for assuming that all equipment will have as small an improvement as the best-performing units; there are bound to be some whose improvement rates will be greater. In the absence of a better estimate, and recalling that Verizon bears the burden of proof, a current estimate of 25% should be substituted for Verizon's 10% and averaged with the 60% of the First Proceeding.

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[107] Tr. 2,378.

[108] As already noted, my recommended approval of the FLC, which is premised on avoiding any double counting of TELRIC adjustments that may result from their presence in both the numerator of the ratio and the investment base to which it is applied, makes it even more important to ensure that the numerator reflects all forward-looking cost reductions.

Other Support ACF

The "other support" ACF recovers expenses related to information management, research and development, and procurement as well as expenses and capital investments associated with various non-revenue producing investments such as motor vehicles and general purpose computers. The CLEC Alliance objects to this recovery of shared costs through an annual cost factor applied to capital investment, arguing that the shared costs are also related to expenses[109] and "should not differ proportionally based on investments."[110] The CLEC Alliance characterizes this ACF, as applied by Verizon, as a "capricious and arbitrary ACF cost booster,"[111] and it urges application of this factor, like the common overhead factor, to expenses rather than to investments.[112]

Verizon responds that nearly all expenses recovered through the other ACFs similarly relate in part to expense as well as investment, but that application of a factor to investment is an accepted and fair way to recover the costs.

Verizon's response is persuasive; there is no need to modify this ACF.

Wholesale Marketing ACF

The wholesale marketing ACF captures the expenses of "advertising, product management and customer interfacing functions."[113] Verizon claims to be seeking recovery only of the

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[109] CLEC Alliance's Initial Brief, p. 21.

[110] Id., p 22.

[111] Id., p. 23.

[112] The CLEC Alliance's position in this regard appears to be opposed to that of the CLEC Coalition, which objects, as noted above, to assignment of the common overhead factor on the basis of expenses and urges continuation of the previous practice of assigning those expenses, too, on the basis of investment.

[113] Verizon's Initial Brief, p. 59.

costs that would be incurred in a wholesale market, contending that it eliminated retail avoided costs. CLECs urge reduction or elimination of all advertising costs as well as reduction of product management costs.

AT&T characterizes as "absurd" the recovery of any advertising expenses, contending that allowing it requires CLECs to pay twice for advertising--once to Verizon and once through their own advertising channels.[114] It notes that the Commission in the First Proceeding required Verizon to treat 90% of its advertising expenses as retail avoidable, asserts that Verizon has never advertised UNEs,[115] and contends that the full page ads in Telephony magazine that Verizon had cited as being directed to wholesale customers promoted services other than UNEs. WorldCom argues to similar effect, noting that Verizon has not advertised UNEs or placed brand awareness or market stimulation advertising related to UNEs; it asserts that Verizon's continuing bottleneck monopoly over local exchange facilities largely negates any incentive to advertise and that advertising to stimulate additional CLEC market activity could lead Verizon to lose additional retail customers. It cites Verizon's statement at the hearing that it had not found such advertising to be warranted by cost/benefit analysis.[116] The CLEC Alliance adds that brand awareness campaigns--analogous to Intel's "Intel Inside" stickers on computers--would be inapposite here, and that Verizon in fact forbids its CLEC customers to use its trademark, inasmuch as the CLEC is its retail competitor as well as its wholesale customer.[117] Z-TEL argues to similar effect, characterizing the wholesale marketing costs as speculative.

Verizon takes a very different view of advertising, challenging as an improper "backward look" the CLECs' emphasis on the fact that Verizon is not now conducting wholesale

[114] AT&T's Initial Brief, p. 61.

[115] Tr. 5,205-5,207.

[116] WorldCom's Initial Brief, p. 65, citing Tr. 5,215.

[117] CLEC Alliance's Initial Brief, p. 16.

advertising. It contends that in the fully competitive market contemplated by TELRIC, in which Verizon would be an exclusively wholesale provider, it would undertake market stimulation advertising, brand awareness advertising, and advertising to CLECs themselves. It points to the Commission's historical allowance of advertising costs even to pre-competitive utilities and to the need to distinguish Verizon's products from those of other providers of wholesale services. It asserts as well the need to advertise to CLECs themselves, citing the advertisements already placed by alternative providers of telecommunication services in the trade press,[118] and it notes that, since the close of the hearings, it has placed advertisements in trade journals extolling its own network services in contrast to those of other providers. It adds that the wholesale-only premise, and the inquiry into whether the costs at issue are retail-avoidable, are inconsistent with the Eighth Circuit's decision. In its view, the decision means that the pertinent inquiry is into "whether Verizon, as a company engaged in both retail and wholesale operations, would actually avoid particular costs."[119]

With respect to product management expense, Verizon regarded 49.73% of the account to be retail-avoidable. AT&T and the CLEC Alliance regard that figure as greatly understated, contending that a detailed review of function codes suggest a much higher avoidable percentage. Pointing for example to the expense of maintaining tariffs, AT&T contends that Verizon's retail tariffs far outweigh in volume its wholesale tariffs, and the CLEC Alliance suggests that even wholesale tariffs include restrictive provisions whose purpose is not to incur wholesale sales but to assist Verizon's retail operations. They suggest that 90% of product management expenses be treated as retail-avoided.[120]

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[118] Verizon's Initial Brief, p. 62, citing Tr. 3,323-3,324.

[119] Verizon's Reply Brief, p. 45 (emphasis in original).

[120] AT&T's Initial Brief, p. 63; CLEC Alliance's Initial Brief, p. 18.

Verizon regards the 90% figure as arbitrary inasmuch as it is based on no workpapers or data, and it insists that the product management costs that remain after its own 49% adjustment--an excessive adjustment under the Eighth Circuit decision, it adds--will continue to be incurred in a wholesale environment. They include not only tariff-related costs but also the costs of meeting CLEC customers and responding to their questions. It notes, for example, AT&T's admission in an interrogatory response that Verizon's wholesale network services group meets regularly with AT&T representatives,[121] and it sees no record basis for assuming that this group and its resulting costs will disappear in the future.

Finally in this regard, the CLEC Alliance objects to the recovery of operator services and directory assistance(OS/DA) costs through UNE rates, noting that OS/DA is not a UNE itself and that Verizon is proposing to offer and price it as a non-regulated service. It contends that Verizon has treated zero percent of OS/DA costs as retail avoided, which incorrectly assumes that all CLECs will use Verizon's OS/DA services and thereby drives up the costs of UNEs for CLECs that do not use OS/DA services. CLECs that choose to take Verizon's OS/DA services will pay for it separately, and the associated costs, says the CLEC Alliance, should not be recovered through UNE ACFs generally.

Verizon makes a strong case for its position on product management expense. Given the continuing need to work with its CLEC UNE customers, as demonstrated by ongoing activities of that sort, I see no basis for assuming a greater portion of these costs to be avoided.

Advertising is another matter. It may overstate the case to say no advertising costs would be incurred in a wholesale-only environment, and Verizon appears to have begun at least some advertising of its network to UNE purchasers. But the factors that warranted treating 90% of these costs as retail

[121] Tr. 3,326.

avoidable remain, for the most part, in place; among other things, there is little reason to anticipate brand awareness campaigns. In view, however, of the advertising that is now underway, the disallowance should be reduced to 85%.

The CLEC Alliance makes a valid point with respect to not imposing OS/DA costs on CLECs that choose not to take those services from Verizon. Verizon's silence in response may indicate agreement; in any event, its proposed rates already distinguish between CLECs that take OS/DA service and those that do not, so no further adjustment is needed on that account.

Finally, parties may use their briefs on exceptions to present, in greater detail, their views on the implications of the Eighth Circuit's decision for this issue.

Common Overhead ACF

"The common overhead ACF reflects common overhead expenses, SPE [Special Pension Enhancement] or equivalent expenses[,] and savings from the Bell Atlantic/NYNEX merger."[122] The three components are discussed separately.

1. Common Overhead Expenses

Common overhead expenses are those associated with activities, previously designated as "general and administration (G&A) functions," including executive, planning, general accounting and finance, external relations, legal, and human relations. In contrast to the First Elements Proceeding, where these expenses were recovered through an expense-to-investment factor, Verizon here proposes to recover them through an expense-to-expense ratio; as noted, the principal practical effect of the change is to allocate a portion of these expenses to nonrecurring charges, which are calculated on the basis of expense rather than investment.

WorldCom contends that historical one-time expenses (such as those related to Y2K concerns) should be excluded from

[122] Verizon's Initial Brief, p. 63.

the overhead deemed recoverable in a TELRIC calculation and that the FCC has so held in its Universal Service Proceeding.[123] It recommends application of an adjustment comparable to the 20% adjustment that the FCC there applied to the executive, planning, and G&A overheads in Account 6700. Verizon responds that WorldCom has not shown that its proposed adjustment is comparable to the FCC's and that, in any event, WorldCom misreads the FCC's Universal Service Proceeding decision, which does not address the pricing of UNEs. In contrast, it continues, the Local Competition Order establishes the right of ILECs to recover the reasonable costs they will incur; that principle was affirmed in the recent decision in WorldCom's lawsuit growing out of the First Elements Proceeding and other Commission actions[124]; and WorldCom has not shown that Verizon will experience a 20% reduction in these expenses. With specific reference to Y2K costs, Verizon reiterates its earlier claim that they served to defer the incurrence of costs for other planned projects.

The CLEC Alliance urges that lobbying, legal, and regulatory costs be removed from the overhead calculation, characterizing as "irrelevant" Verizon's claim that lobbying costs are "below the line" and not used in developing ACFs.[125] It regards such legal efforts and lobbying as inevitably adverse to CLEC's interests and as benefiting Verizon's retail offerings. Verizon responds that lobbying expenses are not included and characterizes as "frivolous on its face" the suggestion that legal and regulatory costs should be excluded, contending they are necessary costs of operation that all companies recover in their prices.[126]

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[123] WorldCom's Initial Brief, p. 61.

[124] Verizon's Reply Brief, p. 43, citing MCI Telecommunications Corp. v. New York Telephone Co., No. 97-CV-1600, slip op. p. 22 (N.D.N.Y., March 7, 2001). That decision is discussed further below.

[125] CLEC Alliance's Initial Brief, p. 25.

[126] Verizon's Initial Brief, pp. 68-69.

While the 20% adjustment is unsupported and the Universal Service Order may be inapposite, Y2K expenses are inherently a one-time event. And while it is certainly possible that the deferral of other projects avoided an overall cost balloon in the year in which they were incurred, Verizon, though bearing the burden of proof, has not shown that to be the case. The common overhead ACF should be recalculated to exclude costs related to Y2K efforts; Verizon should include, in its brief on exceptions, an estimate of those costs.

The CLEC Alliance's proposal should be rejected. As Verizon notes, the lobbying expenses are already excluded, and reasonable legal and regulatory expenses are necessary and allowable costs of doing business.

2. Special Pension Enhancement

This venerable issue involves Verizon's proposal to recover certain costs associated with offering enhanced retirement benefits in order to reduce its workforce. In Phase 3 of the First Proceeding, the Commission denied Verizon's request to recover some $387 million of such costs. It cited procedural grounds, related to the timeliness of the claim; and substantive grounds, including, among other things, the need to recognize possible offsetting savings. Despite that denial, it authorized renewed consideration of the issue in this proceeding, albeit on a prospective basis only, and it added, in response to AT&T's request for rehearing, that Verizon bears the burden of showing any allowance to be procedurally and substantively proper.[127]

In the present proceeding, Verizon seeks to recover some $400 million of SPE, a figure based on the average of 1998-1999 SPE expense, adjusted to remove avoidable retail costs. It argues that its cost studies already reflect a very optimistic

[127] Phase 3 Opinion, pp. 21-22; Phase 3 Rehearing Opinion, pp. 6-7. A full discussion of the issue's background appears in the Phase 3 Recommended Decision (issued October 2, 1998), pp. 18-20.

view of possible offsetting savings but that these savings "can be realized only if Verizon continues to restructure its workforce in the same way that it has in the recent past. Such restructurings necessarily require the expenditure of SPE costs."[128]

AT&T objects to recognition of SPE costs, regarding such recognition as contrary to both TELRIC and Commission precedent and characterizing the costs as ones "that Verizon must absorb to rid itself of excess inefficient layers of management and union employees in order to compete effectively in the future"; such costs would not be incurred by an efficient forward-looking company.[129] It contends that the anticipated savings recognized by Verizon provide only a 1.55% reduction in UNE costs while the SPE recovery increases those costs by 4.96%, and it cites the suggestion by Department of Public Service Staff, in a White Paper issued in another proceeding, that Verizon has understated the cost savings that will result from mergers.[130] AT&T insists that "CLECs should not be required to pay for Verizon's inability to develop, and retain, a properly sized, efficient workforce."[131]

Similar arguments are offered by the CLEC Alliance and CLEC Coalition, which stress that the employees to be cut would never have been present in a TELRIC construct and object to allowing Verizon to recover the cost of needed downsizing from its competitors, who must themselves reduce their workforces.[132] The Alliance calculates that removal of the SPE would reduce the overhead loading from 11.9581% to 6.0987%,[133] and the Coalition

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[128] Verizon's Initial Brief, p. 64.

[129] AT&T's Initial Brief, p. 54.

[130] Case 00-C-1945, Verizon New York, Inc. - Cost Recovery and Future Regulatory Framework, Staff White Paper (released January 2, 2001).

[131] AT&T's Initial Brief, p. 56.

[132] CLEC Alliance's Initial Brief, p. 27.

[133] Id., p. 28.

argues that Verizon has failed to demonstrate that the 1998-1999 average cost is typical of what can be expected in future years. It suggests that these are transition costs best viewed as an investment or capital loss, which, if recovered at all, should be recovered over an extended period that allows the matching of benefits to the costs. WorldCom argues in a similar vein, charging that "[Verizon] has long been one of the most inefficient of the larger ILECs in the United States," and that CLECs should not fund its efforts to increase its efficiency.[134] It notes as well that firing employees would avoid the need for SPE payments. Z-TEL argues to similar effect.

Verizon's position on the item stresses the need for any corporation in a dynamic environment to restructure its workforce on a regular basis, and Verizon disputes what it characterizes as AT&T's view that TELRIC requires the assumption of a totally static situation. It argues that retirement incentives are commonly used in connection with restructuring workforces and that AT&T itself has restructured its workforce on a number of occasions without claiming that the steps are needed to remove excess and inefficient layers of employees. Verizon asserts that competitive forces will, if anything, require more such restructurings in the future and that there is no reason to assume that the costs would be avoided in a TELRIC construct. It maintains that AT&T has taken too narrow a view of the savings to be compared with the SPE expense (which should include, as well, the overall productivity adjustments); that there is no basis for assuming that firings could have been an equally effective way to restructure Verizon's workforce; and that data for the six years from 1994 through 1999 confirm the reasonableness of the amount included in Verizon's study.[135]

In the competitive environment contemplated by TELRIC, companies may incur early retirement incentive costs, as Verizon

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[134] WorldCom's Initial Brief, p. 60.

[135] The data are set forth in Exhibit 410, CC-VZ-154 (Revised Supplemental Response).

maintains; and the costs to be allowed here, if any, should reflect the normal level of costs that Verizon could be expected to incur in that environment. Verizon seeks $400 million of costs, roughly the average of its 1998 and 1999 actual costs, and it cites data going back to 1994 to confirm the reasonableness of those figures. But the data in CC-VZ-154 show considerable variation in those costs over the years in question (and that 1998 and 1999 are the second and third highest of the six years), calling into question its reliance on the two-year average. More importantly, the six years encompass two unusual mergers--NYNEX/Bell Atlantic and Bell Atlantic/GTE--that could be expected to involve unusual levels of early retirement, as well as the transition from monopoly to competition. The CLECs' arguments about Verizon's historical inefficiency may well be overstated, but there is little doubt that regulation cannot be as effective as competition in keeping costs down. As a result, the movement from regulated monopoly to competition will likely involve a degree of workforce reduction that cannot be expected to continue in the competitive environment, and those transitional costs should not be recovered in a TELRIC construct, whose assumptions include a properly sized workforce.

Taking all these factors into account, it is impossible to conclude that Verizon has borne its burden of proving the level of SPE payments it could be expected to incur in a forward-looking TELRIC environment. Its claim for $400 million should be rejected, and there is no basis on this record for identifying some lower amount. (The factors noted above are significant enough to sustain a qualitative judgment that the actual amount is likely to be closer to zero than to $400 million.) In addition, as already noted, allowance of the FLC adjustment requires special diligence to be sure that all forward-looking expense reductions are properly reflected. Accordingly, SPE recovery should again be denied.

3. Merger Savings

Verizon asserts that the common overhead ACF reflects the savings associated with the NYNEX/Bell Atlantic merger that were presented in its filing of December 22, 1999 in Case 95-C-0657, adjusted to remove retail costs and in certain other respects.[136] It objects to reflecting further savings associated with the Bell Atlantic/GTE merger, contending that it is too early to tell what percentage of those savings should be attributed to New York intrastate regulated operations and, in any event, whether further adjustments are needed in light of the productivity already recognized.

AT&T disputes Verizon's view that it is premature to reflect Bell Atlantic/GTE merger savings, noting potential sources of such savings, but it does not attempt to adjust Verizon's presentation on their account and simply suggests "it would not be inappropriate" for the Commission to do so.[137] The CLEC Alliance asserts that the Bell Atlantic/GTE merger will lead to reduced corporate overhead expenses, including those associated with the departure of senior executives, and it cites the Commission's statement in approving the Bell Atlantic/GTE merger that a portion of the merger savings should redound to the benefit of New York consumers. It offers no specific estimate but asks the Commission to require further reductions in UNE rates to recognize additional merger savings. WorldCom notes the stated expectation, in a 1998 annual report, that the Bell Atlantic/GTE merger will yield annual expense savings of $2 billion by the third year following completion of the merger. It recommends a reduction of 3.57% in the common overhead ACF to reflect Bell Atlantic/GTE merger savings, consistent with the

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[136] The December 22, 1999 filing was made pursuant to the Commission's Phase 2 decision to disallow certain development costs pending a showing that the conditions imposed in authorizing the NYNEX/Bell Atlantic merger, including the flowing through to customers of the merger savings, had been met. Those issues are now being considered in Case 00-C-1945.

[137] AT&T's Initial Brief, p. 66.

adjustment in the HAI Model;[138] the CLEC Alliance advocates a similar adjustment. The Federal Agencies argue that substantial savings provide the only rational justification for the Bell Atlantic/GTE merger, and that there is no reason not to reflect a reasonable estimate of savings in the rates set here.

Verizon responds that its studies were completed before the closing of the Bell Atlantic/GTE merger, and that it will provide an estimate of the savings in Case 00-C-1945, where the matter is being addressed.

There can be no doubt that an estimate of savings associated with the Bell Atlantic/GTE merger should be reflected in the rates set here. Verizon should include an estimate of those savings in its brief on exceptions (which will be due following the date for Verizon's submission in Case 00-C-1945), and all parties should comment on how to reflect those savings, given that rates likely will be set in this case before the conclusion of Case 00-C-1945.

[138] WorldCom's Initial Brief, p. 63, citing Tr. 1,259-1,262.

Depreciation ACF

In Phase 1 of the First Elements Proceeding, the Commission determined that the depreciation lives to be used in estimating UNE costs should be those set for Verizon's predecessor in the FCC's triennial represcription process. Citing both the Local Competition Order's presumption in favor of the prescribed rates and Verizon's failure of proof, it rejected Verizon's proposal to use shorter depreciation lives based on generally accepted accounting principles. It held that the prescribed lives to be used should be those recommended by [the] Commission for New York Telephone, consistent with the FCC's mandate, for intrastate purposes, rather than the lives prescribed by the FCC for Bell Atlantic's Maryland subsidiary, as the Hatfield Model proponents had urged.[139]

Early in the present proceeding, as part of its efforts to assist the parties in identifying issues, Staff stated, in pertinent part, that

> the Commission decided in [the First Elements Proceeding] that TELRIC depreciation rates should be based on depreciation lives used in calculating booked depreciation on a regulatory basis. If the service lives for [Verizon's] plant changed since rates were set in [the First Proceeding], the new service lives and depreciation rates should be used in developing TELRIC element costs.[140]

Claiming consistency with the Commission's earlier decision and Staff's guidance, Verizon urges use of the depreciation lives adopted by the Commission for regulatory purposes effective January 1, 1998. AT&T disputes that claim and urges use of the longer lives (and consequently reduced depreciation cost) set by the FCC in 1995

The depreciation rates that went into effect for regulatory purposes on January 1, 1998 did so, pursuant to the

139 Phase 1 Opinion, pp. 47-48; Phase 1 Rehearing Opinion, pp. 55-56.

140 Staff Memorandum dated August 11, 1999, quoted at Tr. 3,360 and in Verizon's Initial Brief, p. 69.

process called for by Verizon's Performance Regulatory Plan (PRP), following review by Staff. According to Verizon, its cost studies therefore reflect the depreciation lives used for regulatory purposes, using service lives that have changed since rates were set in the First Proceeding, and thus comply with the Staff Memorandum.

AT&T objects, contending, first, that Verizon has simply failed to support its depreciation proposals with the specificity required by the FCC.[141] It contends further that the rates are inconsistent with the Commission's determination in the First Proceeding, which required use of the depreciation rates "most recently prescribed for Verizon"; those, according to AT&T, remain those adopted in Opinion No. 97-2 rather than the much shorter lives here proposed. AT&T notes as well that Staff questioned the rates filed in 1998 and suggested that a full study conducted without the constraints of the PRP might not have reduced depreciation lives to the extent there proposed by Verizon.

AT&T goes on to support its own proposals on the basis of its witness Lee's testimony. It argues that forward-looking pricing requires the use of economic depreciation rates based on the expected economic lives of newly placed plant, and Mr. Lee explained how the FCC's depreciation prescription process had become more forward-looking and offered what he regarded as empirical evidence of that development. AT&T argues as well that Verizon's witness on the subject of depreciation was not a qualified expert, and it disputes his argument that the FCC lives, initially prescribed in 1995, were no longer valid. It notes that the FCC renewed its prescribed life ranges in 1999 and stated then that the lives were appropriate for use by state commissions in establishing UNE prices. AT&T points as well to the use of the FCC depreciation lives in other jurisdictions, each of which, according to AT&T, regarded those lives as forward-looking and appropriate for TELRIC purposes. The CLEC

[141] AT&T's Reply Brief, p. 57, citing Local Competition Order ¶702.

Alliance argues to similar effect, stressing that the rates advocated by Verizon were accepted by Staff in 1998 only in the context of the PRP, and alleging misrepresentation in Verizon's argument that the rates are consistent with those approved for UNE pricing in Opinion 97-02.

Verizon, for its part, sees the question of whether the FCC's depreciation lives are forward-looking as largely irrelevant. It emphasizes that the FCC rates favored by AT&T were set more than six years ago on the basis of even older data and that the Staff Memorandum, like the Commission's order in the First Proceeding, recognized that the PRP provided a mechanism for changing intrastate regulated depreciation lives and that such changed lives should be used in UNE studies. It notes that there was no traditional triennial represcription in 1998 and that the FCC therefore did not review in any detail the continued adequacy of the 1995 rates. It regards as true but irrelevant that the FCC's represcription process has become more forward-looking over the years, and it insists that AT&T has failed to explain why interstate depreciation lives adopted by the FCC in 1995 are better than intrastate depreciation lives accepted by the Commission in 1998. Arguing that the PRP anticipated a continued shortening of depreciation lives in light of the development of competition, Verizon maintains its 1998 study is consistent with that expectation.

Verizon disputes as well the charge that it failed to present a presentation on depreciation, contending that its witness Minion had more relevant expertise than Mr. Lee; that it was not obligated to submit a full-blown depreciation study in view of its reliance on the 1998 effort; and that it has met its burden of overcoming any presumed reliance on the FCC's represcribed rates, given its compliance, consistent with Staff's memo, on the specific process followed in New York. It suggests that the jurisdictions that relied on the FCC's prescribed rates did so in the absence of state-specific alternatives or at a time when the FCC's rates were less stale.

The key to this issue is whether the service lives adopted in 1998 under the PRP are, in fact, changes that should be taken into account pursuant to Staff's August 1999 memo in this case. Two considerations suggest they are not. First, Staff's report on its review of those service lives expresses important reservations:

> Although Staff has reviewed the company's proposals with respect to the benchmark established in the PRP, we did not conduct a full study in the traditional sense and, therefore, have made no recommendations regarding the appropriateness of the company's depreciation parameters in the context of this study. Staff believes that if a full study were conducted without the constraints of the PRP, although we may have recommended reducing projection lives somewhat for certain accounts in the central office and outside plant categories, it does not appear likely that lives would have been reduced as low as those proposed by the company. Likewise, future salvage factors would have correlated more closely to actual salvage experience than those proposed by the company.[142]

Verizon ignores these important qualifications, which suggest strongly that the service lives set in 1998 should not be treated as typical regulatory service lives to be applied here as Verizon proposes. They reflect the special circumstances and constraints of the PRP, and, unlike the 1995 lives, they are not based on a thorough analysis of Verizon's construction program, technological advances, competition, and other factors affecting service lives. Beyond that, the 1998 changes predate Staff's August 1999 memo, and if Staff contemplated using those rates here, it could have said so.

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[142] Letter to Robert Welsh, Bell Atlantic Network Services, from Dennis F. Taratus, Chief-Dominant Carrier Performance, dated June 24, 1999.

Verizon is right to express concern that the 1995 data may be going stale and to stress the superiority of New York-specific servicé lives. But the staleness has not been demonstrated, and the FCC's 1999 action, though not a full-scale represcription, warrants continued confidence in the 1995 rates. Meanwhile, the benefits of New York specificity can be realized by continued use of the depreciation rates actually used in the First Elements Proceeding, and that is my recommendation.

COST OF CAPITAL

Overview

Cost of capital presentations were made by Verizon and by AT&T jointly with WorldCom. Verizon proposed a figure of 12.6%, which it regarded as conservative in light of its study's conclusion that a forward-looking weighted average cost of capital related to the supplying of UNEs would be in the range of 13.03% to 13.38%. AT&T/WorldCom estimated the weighted average cost of capital to be in the range of 9.17% to 9.91%.

The parties differed little in their estimates of the cost of debt, but they held very different positions regarding the cost of equity and the capital structure. The differences reflect in part Verizon's view that it should be seen as a fully competitive enterprise subject to all the associated risks and entitled to a correspondingly higher return on investment and AT&T/WorldCom's contrary view that an incumbent local exchange company remains an inherently less risky operation.

Verizon witness Vander Wiede calculated a cost of equity of 14.78%, based on a discounted cash flow (DCF) analysis of a proxy group comprising the companies included in the Standard and Poors (S&P) Industrials, and a debt cost of 7.77%. It contemplated a debt/equity ratio in the range of 25%/75% to 20%/80%; the former implied an overall capital cost of 13.03%, while the latter implied 13.38%. In its studies, it used a figure of 12.6%, equal to the figure it uses in its own business decisions;[143] in light of Dr. Vander Wiede's calculations, it regarded that figure as conservative.

AT&T/WorldCom witness Hirshleifer calculated an equity cost of 10.42%, averaging the results of a DCF analysis of a proxy group comprising the regional Bell holding companies and the larger independent telephone companies (10.24%) and a capital asset price model(CAPM) analysis (10.6%). It envisioned a capital structure ranging from 54% debt/46% equity to 20% debt/80% equity and an overall cost of capital (assuming a debt cost of 7.86%) ranging from 9.17% to 9.91%; the midpoint of that range is 9.54%.[144]

As a point of reference, it may be noted that the Commission in the First Proceeding adopted a weighted average overall cost of capital of 10.2%, reflecting a cost of equity of 12.1% and a debt/equity ratio of 40%/60%.[145] The decisions underlying that result are discussed below, to the extent pertinent.

Verizon's Presentation

Verizon argues that the cost of capital, no less than other costs, must be determined on a forward-looking basis that contemplates a competitive market, and it criticizes AT&T for inconsistently assuming, in this one area only, a backward-looking market in which Verizon is a near monopolist enjoying the lower cost of capital associated with its lower risk. It charges that AT&T in effect advocates a traditional, regulated, non-TELRIC approach to cost of capital, taking account of book values of debt and equity rather than economic or market values.

Verizon's witness Vander Weide analyzed the risk of providing unbundled network elements in New York. He found relatively high levels of risk associated with the business's

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143 Verizon's Reply Brief, p. 63.

144 Tr. 2,292, reflecting the updated estimates in rebuttal testimony, as slightly increased in a letter to me from AT&T's counsel dated January 31, 2001.

145 Phase 1 Opinion, p. 40.

high leverage, which made it acutely sensitive to changes in revenues, and with the substantial growth of competition in the State, as evidenced by the large number of interconnection agreements between Verizon and its competitors and the competitors' provision of service to more than one million lines. Verizon cites in that regard investors' forecasts that competition will increase and derides what it characterizes as AT&T's "scare campaign,"[146] which attempts to blame regulators rather than AT&T's own missteps for AT&T's failure to make a go of it in the local market; it points to the successful entry of other CLECs, including WorldCom.[147] A third factor said to contribute to Verizon's risk is technological change, which lowers the cost of entry to competitors while endangering Verizon's ability to recover its investments. Finally, Verizon sees risk in regulation itself, which constrains Verizon's operations in comparison with those of its competitors and may require Verizon to incur costs that will not be recovered. Verizon contends that its own risk (i.e., that of Verizon-New York, the New York local exchange company) exceeds that of its parent, which has greater geographic and product diversity, better access to capital markets, and greater potential economies of scope and scale.

In light of these considerations, Verizon asserts that the overall risk it faces in offering UNEs is comparable to the forward-looking risk of the S&P Industrials, which therefore provide a reasonable proxy group to use in determining Verizon's cost of capital for purposes of offering UNEs. Applying a single-growth DCF analysis to that group yielded a cost of equity of 14.78%. In the First Proceeding, the Commission analyzed 11 companies involved in the provision of local exchange service, and Verizon's witness accordingly considered the four remaining telecommunications companies that were not the subject of pending mergers and found a 14.22% cost of

[146] Verizon's Initial Brief, p. 80.

[147] Id., pp. 81-83.